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SURVEY OF THE TREATMENT OF ECONOMIC ACTIVITIES OF NON-PROFIT ORGANIZATIONS IN EUROPE*

I. INTRODUCTION

Economic activities are considered as a key income source for the non-governmental, not-for-profit organizations (NPOs)¹ in countries around the globe. According to the John Hopkins Comparative Research Project (John Hopkins Survey), 53% of NPOs' income in the surveyed countries is generated through fees for services, economic activities, investments and other income generating activities.² Engagement in economic activities enables NPOs to expand the pool of unrestricted resources, but also to develop their services and increase their quality, and to target more effectively the needs of the beneficiaries. In addition, this is an important resource especially for advocacy NPOs, who need to be able to create an independent resource base for implementation of their activities and thus retain a certain degree of independence from the Government.

Almost all European countries allow NPOs to conduct economic activities (directly and/or through subsidiary/company) in order to generate income to support their activities. However, there might be some limitations in terms of the types of activities, or the tax treatment of the income from such activities.

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Unless referenced differently, the country specific information in this paper has been compiled mainly from three resources: (1) "The Survey of Tax Laws Affecting NPOs in CEE" published by the International Center for Not-for-Profit Law (second edition, 2003, www.icnl.org), (2) "Tax Treatment of Non-Profit Organizations and Tax Benefits for Donors", paper developed for a project for the Bulgarian Centre for Not-for-Profit Law (BCNL) under the project "An Optimistic Look at NPOs and Domestic Resources", funded by the Trust for Civil Society in Central and Eastern Europe through the Bulgarian Charities Aid Foundation (2006), and (3) "Economic Activities of Not-For-Profit Organizations", prepared by ICNL (1996).

¹ The term not-for-profit organizations is used in a broad sense to encompass non-governmental legal entities that are variously referred to as association, foundations, non-profit companies, public benefit organizations, charities, civic organizations etc.

² The study included 16 advanced industrialized countries, 14 developing countries from Africa, Asia and Latin America, and 5 countries from Central and Eastern Europe, including the Czech Republic, Hungary, Poland, Romania and Slovakia. See "Global Civil Society: An Overview," Lester M. Salamon, the John Hopkins Comparative Nonprofit Sector Project, 2003 (www.jhu.edu/~ccss).



This paper examines the issue NPOs engaging in economic activity for profit with the aim to address the two questions of whether such activity is allowed at all and, if so, what are the tax consequences? It addresses these questions within the context of Europe with the focus on the Central and Eastern European (CEE) countries.³ The paper provides both a survey of current practices and an analysis of the rationales and strengths and weaknesses of the various approaches.

Part II briefly outlines the legal characteristics of NPOs and what differentiates them from for-profit entities. Part III discusses “economic” and “commercial” activities in order to define which types of NPO activities lie within the scope of this paper. Part IV deals with the question of whether NPOs are permitted to engage directly in economic activities. It discusses the exceptions to the general rule of permitting economic activity and the various restrictions that may apply when economic activities are allowed. Part V deals with the tax consequences to NPOs when they engage in economic activities. It explains the various approaches adopted by the surveyed countries and the rationales and strengths and weaknesses of each approach.

II. LEGAL CHARACTERISTICS OF NPOs

It is helpful to initially spell out what distinguishes an NPO from a for-profit entity from a legal perspective.

First, an NPO must be organized and operated primarily (but not exclusively) for some purpose other than private gain. Generating some profit is not prohibited as long as the NPO’s primary purpose is not for profit.

Second, NPOs are prohibited from distributing net revenues to private parties who may be in a position to control the organization for personal gain, such as founders, members, officers, directors, agents, and employees. This *principle of non-distribution* does not generally extend to distributions, even to private parties, which are designed to further public benefit purposes, such as charitable donations to the poor.

A third assumption is that the organization’s characteristics, not its organizational form, are determinative of NPO status. That is, the activities and purposes of the organization are more important than the characterization of its legal personality, be it an

³ The notion: Central and Eastern Europe in the Report pertains to the following countries: Bulgaria, Hungary, Latvia, Lithuania, Estonia, Romania, Czech Republic, Slovakia, Slovenia, Poland, Croatia, Serbia, Bosnia and Herzegovina, Macedonia, Montenegro and Kosovo.



association, foundation, trust, non-profit company, or even, under some legal systems, an unregistered and unincorporated organization.

III. DEFINITION OF “ECONOMIC” AND “COMMERCIAL” ACTIVITIES

Generally speaking, “economic activities” mean the active sale of goods or services, referred to as “trade or business” activities; it entails sale of goods and services that are pursued with the frequency or continuity.

There are, however, a number of activities excluded from this definition – i.e., not considered “economic activities” – and therefore outside the scope of this paper.

The first such exclusion is isolated, irregular, or occasional activities which involve the sale of goods or services but which are not pursued with the frequency or continuity of comparable practices in the commercial sector. This would include, for example, raffles, occasional fundraising dinners, and charity auctions.

The second group of NPO activities often recognized as non-economic in nature are those activities primarily or exclusively carried out with volunteer labor and/or donated materials. An example of this would be a thrift- or second-hand store operated by an NPO to generate profits for its public benefit purposes.

The third exclusion recognized by many legal systems derives from historical practices or traditions. This category includes activities considered to be intrinsically connected to the public benefit purposes of certain NPOs. Examples may include admission fees for museums, tuition fees, or fees from patients at not-for-profit hospitals.

In sum, transactions generally deemed not to be “economic” include:

- isolated, irregular, or occasional activities involving the sale of goods or services but which are not pursued with the frequency or continuity of comparable practices in the commercial sector;
- activities primarily or exclusively carried out with volunteer labor and/or donated materials; and
- historical practices or traditions.
- the receipt of purely gratuitous gifts, grants, donations, and contributions;
- the receipt of net revenues from passive investments;
- the use of any funds from the above two to advance the public benefit purposes of the NPO;

Regarding allowable NPO activities, some jurisdictions attempt to create a distinction between “economic” activities and “commercial” activities, treating “economic” activities more permissively. For example, the laws in Hungary distinguish between economic activities related to the statutory purposes and commercial/entrepreneurial activities which “aim at or result in obtaining income and



property" and are unrelated to the statutory activities. All economic activities that are included in the statute of the organization as supporting the mission are not subject to taxation. NPOs need to pay tax only on the income from the commercial/entrepreneurial activity and only if such income exceeds the prescribed threshold in the law (see below).

Most commonly, the issue is whether an NPO's activity has a direct counterpart in the commercial sector, in which case it would be considered not merely "economic" but also "commercial". Other factors have also been suggested to indicate inappropriate commerciality, such as profitable operation and the accumulation of profits, competition with for-profit companies, extensive and successful expansion, and the use of paid workers.

This conceptual distinction between an economic and commercial activity is slippery and difficult to define and implement. Also, in most cases it is not an issue. This paper does not concern itself with distinguishing between the two terms, simply employing the term "economic activities" in all cases, and referring to the commercial activities only when this distinction is clearly applied in the countries analyzed in this paper.

IV. ARE NPOs PERMITTED TO ENGAGE DIRECTLY IN ECONOMIC ACTIVITIES?

A threshold issue is whether and to what extent NPOs are or should be allowed to engage directly in economic activities and retain their not-for-profit status. At this stage of the analysis, the question is not whether such activities are or should be tax exempt, but whether there is or should be a limit to economic activities undertaken by an NPO.

A. Generally permitted

In almost all countries of Europe NPOs are generally permitted to engage directly in economic activities. There are, however, exceptions to this general rule, and even when economic activity is allowed, it is only allowed under certain conditions.

B. Exceptions: Direct economic activity not allowed

Some countries have limited the ability of some forms of NPOs to directly engage in economic activities. For example, in the Czech Republic foundations and funds are limited to renting property and organizing cultural, educational, social and sports activities, and lotteries and collections. In Slovakia, direct economic activity is not allowed for foundations or non-investment funds. In Macedonia associations and



foundations must found a joint stock company or limited liability company in order to engage in economic activities.

C. Limiting conditions for engagement in economic activities

Most countries have set requirements that determine the ability of NPOs to engage in economic activities. For example, article 3 of the Bulgarian Law on Non-Profit Legal Entities provides for the following conditions:

- (1) *Legal persons with non-profit purposes are free to determine the means for achieving their purposes.*
- (2) *Restrictions on the activities and on the means for achieving the purposes of the legal persons with non-profit purposes can be imposed only by law.*
- (3) *Legal persons with non-profit purposes can engage in additional economic activities only if they are **related to their main statutory activity as registered, and if they use the revenue to achieve their statutory purposes.***
- (4) *The type of economic activity is determined in the statute or the articles of incorporation of the legal person with non-profit purposes.*
- (5) *Legal persons with non-profit purposes may conduct economic activity according to the laws governing the respective type of economic activity.*
- (6) *Legal persons with non-profit purposes do not distribute profit.*

1. Statutory purpose

The most common requirement on NPO economic activity employs the notion of statutory purpose.

a) Economic activity related to statutory purpose

The first and most common condition of these requires that the economic activity be related to the organization's statutory purpose. Although the specific language may vary, the principle remains the same. For example, Bulgaria allows only economic activity "*related to [the organization's] registered statutory objective.*" Estonia allows economic activity which "*corresponds to the purposes stated in the Articles of Association.*" The countries with this requirement include Albania, Bulgaria, Croatia, Estonia, Lithuania, Romania, and Slovenia.

b) Income from economic activity used to support statutory goals

A second condition related to statutory purpose requires that income from economic activities be used solely to support statutory goals. That is, instead of focusing



on “whether” the economic activity is related to the organization’s statutory purpose, this requirement focuses on “how” the income from such activity is used. Bosnia & Herzegovina and Bulgaria use this requirement.

2. Incidental/auxiliary/not primary purpose

Another most common type of condition for economic activity requires that such activity not be the primary purpose or main activity of the NPO but rather an incidental or auxiliary activity. Countries with this restriction include Albania, Latvia, Czech Republic, and Romania.

3. Identified in founding documents

Some countries allow an NPO to engage only in economic activities identified in its founding documents. It is used in Croatia and Slovenia. For example, Croatia allows NPOs engagement in economic activities to the extent it is necessary and only in those activities, which are enumerated in the statute so that the registration authority could review their legitimacy in advance. However, the lack of clear criteria regarding what is considered to be an economic activity is one of the problems in implementing this provision.⁴

4. Registered

In Poland, an NPO can only engage in economic activities if the organization has been registered in the entrepreneurs’ court register. In Montenegro, on the other hand, an NPO can only engage in economic activities if those activities have been registered in the commercial court’s register.

D. Analysis

1. Arguments in favor of allowing NPO economic activity

There are two principle justifications for allowing NPOs to engage directly in economic activity. The first is that it plays a critical role in the sustainability of the NPO sector. Income from economic activities is a primary source of funds for NPOs (particularly in countries in a transitional phase where there is a dearth of private capital

⁴ Hadzi-Miceva, K., “A Supportive Financing Framework for Social Economy Organizations”, paper developed for and presented at a conference on Social Economy in CEE: Emerging Trends of Social Innovation and Local Development, organized by OECD and LEED Program (2005)



and philanthropic tradition), thereby reducing their reliance on government, foreign, and/or private sources of funding. Such reliance can threaten not only the viability of NPOs but also the independence and autonomy of the NPO sector. Deprived of their own independent means of financing, NPOs may have to stray from their core mission and cater instead to those goals for which grants and funding are available. Furthermore, government and foreign aid usually does not continue indefinitely. Indeed, foreign donors have already begun to phase out of the CEE region, forcing local NPOs to find alternative sources of funding.

The second justification is that certain economic activities can directly accomplish an NPO's public benefit purposes. For example, if an educational organization sells a book on teaching techniques, this not only serves an economic benefit to the organization but also serves the public benefit purpose of promoting education. Preventing NPOs from using economic means to attain their goals may directly impair their ability to serve their public benefit purposes.

The third justification is that to prohibit is not to prevent. It would seem better to regulate economic activity than to encourage it to go 'underground – and thus inflict harm to fair competition, which will be more difficult and costly to remedy.

Allowing NPOs to generate income could lead to an increased level of effectiveness in program implementation and to better quality and more diverse services. For example, charging fees for services and products raises the expectation of beneficiaries to receive a higher quality of service. This triggers the institutional mindset of NPOs, who become more aware about the need they aim to address and the value of services they provide to their beneficiaries. In addition, the ability to engage in income generating activities encourages NPOs to consider services that they could not otherwise provide for through other funding sources. Finally, the ability of beneficiaries to choose the service provider raises competition among NPOs, which leads to better quality of services and enhances the effectiveness of their work.⁵

2. Arguments against allowing NPO economic activity

The main argument against allowing direct NPO involvement in economic activity is that it could create unfair competition with for-profit entities. While this is essentially a tax issue (i.e., that NPOs often get preferential tax treatment and, thus, an unfair advantage vis-à-vis the for-profit sector), proponents of this viewpoint also contend that NPOs have a competitive advantage over the for-profit sector because they are not required to expend as much capital to achieve the same result.⁶ As NPOs operate

⁵ Hadzi-Miceva, K., "A Supportive Financing Framework for Social Economy Organizations", paper developed for and presented at a conference on Social Economy in CEE: Emerging Trends of Social Innovation and Local Development, organized by OECD and LEED Program (2005)

⁶ See infra section V for a discussion of how countries deal with the NPO taxation issue.



to serve the public benefit, they have a built-in positive reputation with consumers and need not engage in public relations and advertising to the same extent as for-profit entities do. In addition, NPOs often have access to bigger pool of human resource in the form of volunteers and consequently spend less on wages thus giving them another advantage over their for-profit counterparts.

A second argument is that allowing NPOs to engage directly in economic activities may result in mission drift. The promise of earning revenue to invest in their organization may divert the attention of NPO managers from their core non-profit public benefit purposes.

A third argument is that allowing NPOs to engage in direct economic activity may enable some organizations with for-profit intentions to organize and operate under an NPO guise in order to achieve NPO benefits, reducing their tax payments and obtaining a competitive advantage over other for-profit entities. Not only can this result in unfair competition but may also lead the public to view NPOs as an illegitimate means of avoiding taxation. This image, once created by even a limited number of NPOs, damages the reputation of the entire sector.

V. TAX TREATMENT OF INCOME FROM ECONOMIC ACTIVITIES

The tax treatment of the income from economic activities differs widely among the countries of Europe. Some countries, such as Albania, Macedonia, the Netherlands and Slovenia, tax all income from economic activities. Others prescribe certain conditions, which must be fulfilled for the organization to benefit from profit tax exemption.

The first difference among the countries relates to the types of organizations that receive the exemption from profit tax. The following models are represented in the region:

- A broad range of NPOs are eligible to claim exemptions (e.g., Czech Republic, Croatia, the Federation of Bosnia and Herzegovina, Hungary, Latvia, Lithuania, Romania, Serbia, Montenegro and Slovakia).
- Only those NPOs that engage in certain types of activities intended for public benefit or organizations that have attained public benefit (PBOs)⁷ status or

⁷ The public benefit status essentially distinguishes between organizations that are established for the mutual interest of the members, such as sailing clubs, from those whose activities benefit a larger community. Countries generally list the type of activities that are considered of public benefit and prescribe the criteria to further define the status. For more see: "A Comparative Overview of Public Benefit Status in Europe" developed by ICNL and ECNL for MCIC (2007); www.ecnl.org



charitable status (e.g., Albania, England, Estonia, Ireland,⁸ Kosovo, Poland) are eligible to claim exemptions. The definition of public benefit activities differs, but generally these countries consider the following activities to be of public benefit: charitable, humanitarian, environmental, education, etc.

- Very limited categories of organizations are eligible for tax exemptions. For example, in the Republic of Srpska, only legal entities that engage in labor and professional rehabilitation and employment of people with disabilities are exempted from corporate income tax.

Further, different countries use diverse methods to determine the extent to which the income from economic activities will be tax exempt. Generally, countries employ different methods in order to restrict the use of economic income, so as to ensure that the economic activity remains a supplemental, rather than the primary activity of an NPO.

A. Generally tax all profits

One approach is to tax all NPO profits derived from direct economic activity. The following countries generally tax all profits, with some exceptions as indicated: Albania, Bosnia (Republika Srpska)⁹, Bulgaria¹⁰, Slovenia.

- Rationale

The main argument for full taxation of NPO economic activities is that if they are not taxed there is potential for NPOs to gain a competitive advantage over for-profit organizations. Some argue that tax-exempt profits give NPOs higher post-tax rates of return on their business activities than for-profit organizations. Tax-free profits may also enable NPOs to maintain lower profit margins on their economic activities. This advantage could be used to reduce prices on goods and services below levels which are competitive, or even sustainable, on the part of for-profit organizations. Additionally, an NPO may use tax savings to reinvest in economic activities in a way non-exempt for-

⁸ For example, in Ireland the Revenue Commissioners determine which is granted charitable tax exemption. This body will be issued a charity reference number e.g. CHY 1111 and this CHY number needs to be quoted in all future correspondence with Revenue. For more see www.revenue.ie

⁹ As noted above NPOs (other than those engaged in labor and professional rehabilitation or employment of disabled persons) are subject to corporate income tax. As discussed infra in section V(B)(1), there is no taxation of NPO profits in the Federation of Bosnia & Herzegovina.

¹⁰ NPO income from economic activities is taxed. However, social and health insurance funds established by law, scientific budget institutions, universities, and state, municipal and private schools are entitled to a 50% remittance of the tax on income directly connected or auxiliary to their main activity. The Bulgarian Red Cross is entitled to 100% remittance. The remittance is accounted for by the organization as a reserve and must be invested in the main activities of the organization.



profit organizations could not. Also, tax exemptions may provide NPOs with a larger capital base, which can be used to finance expansion and outbid for-profit organizations for land and facilities. In summary, proponents of this approach argue that with the possible exception of certain traditional public benefit activities, it is necessary to tax all economic activities to place NPOs and for-profit organizations on an equal footing in the marketplace. This argument often has strong appeal. For example, this fear prompted the Croatian legislature to pass a law pertaining to this perceived competitive advantage.¹¹ Income from economic activities by NPOs may be subject to tax if the Tax Administration finds that exempting that income would result in the NPO's gaining an "unjustified privileged position in the market," in which case the economic activities are taxed at a rate of 20%.

A second argument in favor of full taxation is that NPOs enjoy competitive advantages over for-profit organizations separate from tax exemptions, thus eliminating the need for further subsidization. As mentioned above,¹² NPOs may already have a competitive advantage over the for-profit sector because they are not required to expend as much capital to achieve the same result. As NPOs operate to serve the public benefit, they have a built-in positive reputation with consumers and need not engage in public relations and advertising to the same extent as for-profit entities. In addition, NPOs often have access to free labor in the form of volunteers and consequently spend less on wages and benefits for their employees, giving them another advantage over their for-profit counterparts. Also, in addition to generating income from economic activities, NPOs may also be receiving government funds and private donations. Proponents would argue that these non-tax benefits eliminate the need to provide NPOs with tax benefits.

Third, the full taxation approach is easier to administer since NPOs are treated like any other organization for tax purposes. And fourth, full taxation eliminates the possibility and therefore minimizes the potential for abuse by organizations attempting to take advantage of NPO tax preferences.

There are, of course, strong arguments against the full taxation approach or, put another way, in favor of some sort of preferential tax treatment for NPOs. These are discussed in the following sections.

B. Full exemption/no taxation

Some countries fully exempt income from economic activities. For example, in the Federation of Bosnia and Herzegovina NPOs are not subject to corporate income tax and therefore all of their income from economic activities is exempted from taxation.

¹¹ See section V(G).

¹² Section IV(D)(2).



In Croatia associations and foundations are generally exempt from profit tax. However, if an organization performs for-profit activity and if exemption from the tax would give the organization an “unjustified privileged position in the market” then such income will be taxed at the regular tax rate. The law does not define what will constitute “an unjustified privileged market position” and it therefore leaves it up to the tax administration to determine on case-by-case basis.

As noted earlier, in Hungary all NPOs are exempted from profit tax on income from economic activities (however are taxed on the income from commercial activity as explained below)

- Rationale

The main reason to fully exempt NPO from taxation of income from economic activities, is that such NPOs often lessen the government’s burden to provide similar services and so NPOs need to rely on own income generation to implement them. The government is compensated for the loss of tax revenue (which results from exempting the income from taxation) by its relief from this financial burden, which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

Further, giving NPOs a competitive advantage (through exemption in taxation) in certain fields may serve the public as NPOs are often able to identify needs and solve problems more quickly and efficiently than government bureaucracies. Also, NPOs are often able to provide needed services at a lower cost and higher quality than for-profit organizations, which are bottom-line driven.

Taxing NPOs depresses the development of the NPO sector. This is a particularly apt argument under a tax regime which requires NPOs to pay tax on economic activities even when they are related to their public benefit purposes. In the latter case NPOs are limited in their ability to financially sustain their operations. Such an approach also fails to provide incentives for NPOs to engage in public benefit activities involving an economic component (e.g., an association for the blind selling walking canes) since these activities would be subject to full taxation.

Finally, as to the argument that giving NPOs preferential tax treatment results in unfair competition with the for-profit sector, it has been argued that empirically such concerns are largely unfounded and the negative impact on the for-profit sector overestimated. First, small businesses are often able to avoid profit taxes by means unavailable to NPOs. Large salaries and expensive offices may allow small businesses to substantially reduce paying income tax. Indeed, several countries have abolished small



business profits tax due to their failure to collect. Second, small businesses are eligible to receive loans from lending institutions, whereas NPOs are generally ineligible for loans. Third, economic activities in which NPOs take part generally fall in the province and jurisdiction of the not-for-profit sector and therefore do not compete with for-profit entities. This is especially true when a country uses the “relatedness” approach to NPO tax exemption.¹³

C. Destination of income approach

This approach looks at the *destination* of the NPO’s income – or what are the purposes for which the income is used. Under this approach, income used for charitable or public benefit purposes is tax exempt; all other income is taxed. While some countries use this approach in its pure form, others place a ceiling (threshold) on tax exempt income, even if it is used for charitable purposes.

Countries that exempt all income which is used for charitable or public benefit purposes include Kosovo (No tax for PBO-status NPOs if income is used for public benefit purposes¹⁴) and Poland (No tax if income is devoted to public benefit goals specified in the tax law¹⁵).

▪ Rationale

This is a desirable approach in many ways. First, it is based on the premise that tax exemptions should only subsidize activities which benefit the public, so only income actually spent in furthering public benefit purposes should be tax exempt. Proponents argue that tax preferences are appropriate for activities which would or should otherwise have to be undertaken by the government to improve the situation of the citizenry.

Second, although this approach does require a (sometimes difficult) determination of whether income has been spent for public benefit purposes,¹⁶ generally speaking it

¹³ See section V(D).

¹⁴ Non-PBO NPOs are taxed to the extent they exceed allowable expenses for the reporting period

¹⁵ However, the tax exemption does not apply to certain economic activities, including the production of alcoholic beverages, tobacco, fuel, electronic devices, or production or trade of precious metals.

¹⁶ For example, what connection is required between the expenditure and the NPO’s purpose? Money spent on food for the poor is key to the goals of a foundation fighting hunger. But is job training (arguably enabling the beneficiaries to find employment which would result in money for food) sufficiently related? What about childcare services which would enable the beneficiaries to search for employment? It is difficult to draft and implement legislation or regulations that adequately define the required connection between the expenditure and the public benefit purpose. Therefore, determinations must often be made on a case-by-case basis.



avoids the complex analysis required in some other approaches, such as the relatedness test, discussed below.

Third, when there is no limit to the exemption, this approach provides the greatest level of financial support to NPOs since, as long as income is devoted to public benefit purposes, NPOs do not incur any tax liability. Of course, this “advantage” is a matter of perspective. From the government’s point of view this is a disadvantage as this approach would probably generate the least amount of tax revenue. This revenue loss can, however, be limited by imposing a ceiling on the amount of income exempt from taxes, a “threshold” approach discussed in the next section.

The main criticism of this approach is that it creates unfair competition. For example, under this approach, if an NPO established to aid the poor earned income from the manufacture and sale of radios, such income would be tax exempt if used for public benefit purposes. The NPO would probably be competing with other for-profit manufacturers of radios who would be paying taxes on whatever profits they earn and would therefore have to sell the radios at a higher price. Thus, this approach risks potentially negative macroeconomic consequences for the business sector. Indeed, the United States abandoned the destination of income approach in favor of a relatedness approach due to unfair competition concerns.

Another criticism of this approach is that it allows NPOs to engage in income-generating activities completely unrelated to their goals, with various possible negative consequences. First, it may divert an NPO’s attention and energies away from the purposes and goals for which it was established. Second, this approach may lead the public to view NPOs as nothing more than for-profit businesses in disguise. Third, more than other approaches, it may attract unscrupulous individuals seeking to use an NPO for tax evasion purposes.

D. Relatedness approach

This approach looks to the *source* of the income. Under this approach, NPO income is tax exempt if it derives from economic activities sufficiently related to the public benefit purposes of the organization.¹⁷ Generally the activities that are considered as unrelated to the statutory goals will be taxed same as other entities. This is the case of Latvia.

▪ Rationale

¹⁷ This is the approach used in the U.S. This approach is also generally used for the exceptions (e.g., in Bulgaria) to the otherwise full-taxation approach discussed in section V(A). That is, these exceptions typically look to the source of the income.



The related nature approach attempts to address concerns of unfair competition and it makes theoretical sense. Often, the most effective way for an NPO to achieve its purposes is to pursue them through economic means. For example, NPOs which assist certain disadvantaged groups within society would find it natural to produce and/or distribute products that serve that group (like medical devices for people with disabilities). NPOs supporting cultural causes often publish informational materials or charge admission to cultural events. Such activities are a logical extension of the goals of the NPO. As long as the public benefic goals remain the principle purpose of the NPO and the income is not improperly distributed, exempting profits from such related activities is appropriate and justifiable.

A second argument in favor of this approach is that it does not provide NPOs with tax advantages over for-profit entities in “unrelated” fields as there is little incentive for NPOs to become involved in activities which are not related to their public benefit purposes. Tax preferences are only provided for publicly beneficial activities. For these activities, deemed particularly worthy of support by society, claims of unfair competition by for-profit organizations might deserve a less sympathetic ear. Also, “related” activities are often naturally within the jurisdiction of the NPO and may be of little commercial interest to the for-profit sector. In addition, it is possible to cap the amount of tax exempt “related” income to reduce concerns that this preference might be abused or exploited.

Third, by exempting only “related” activities, this approach encourages NPOs to engage only in economic activities which are related to their purposes and generally worthy of support. It reduces the temptation to get involved in economic activities merely because they are profitable.

Fourth, in granting such exemptions, governments not only provide additional revenues to NPOs, they also provide incentives and send signals for NPOs to engage in certain forms of behavior. NPOs often perform essential services that would otherwise have to be performed by the government and which might be under-supplied without a tax exemption. Additionally, the not-for-profit sector is often able to identify such need more quickly and meet them more efficiently than governmental bureaucracies. While this argument can be used to justify any governmental support of NPOs, it is much more persuasive when it concerns activities related to public benefit purposes.

Probably the major disadvantage of this approach is that it can be complex to administer since it is often difficult to decide which economic activities are closely enough “related” to satisfy the test. For example, if a museum opens a shop on its premises to sell books about or copies of works in its collection, this is clearly related to the purposes of the museum and should not give rise to taxable income. But what if the museum opens a retail store somewhere else which sells materials about art and culture in general? Geographic location can be important, since a coffee shop on the museum premises would be seen as a natural step to enable visitors to obtain refreshments, which such an establishment on the other side of town should clearly be considered an unrelated activity.



Therefore, it is difficult to draft laws or regulations which adequately codify the concept of “relatedness” and guiding principles must often be established on a case-by-case basis. After a body of decisions or norms concerning application of the rule exists, this is likely to be a less serious problem. But for countries in a state of transition, where guidelines for the not-for-profit sector are still being established, the concept of “relatedness” creates a degree of uncertainty concerning the tax treatment of income. Not only does this create a problem of administration, exposing NPOs to potentially arbitrary administrative responses, but it might deter NPOs from engaging in legitimate income-generating activities.¹⁸

The problematic nature of applying the concept of “relatedness” is demonstrated by the fact that it tends not to result in the collection of much tax revenue.¹⁹ Still, compared to the destination of income approach, this approach creates fewer tax exemptions for NPOs, a negative for NPOs, but more tax revenue, a positive for the government.

E. Threshold approach

1. The Approach

As already mentioned, this approach places a ceiling on NPO tax exemptions in monetary terms, percentage terms, or both. For the countries surveyed, this approach, when present, is always combined with another approach (i.e., a hybrid approach). For example, the Czech Republic, Serbia, and Montenegro combine this approach with the destination of income approach. And Hungary and Slovakia combine this with the relatedness approach.

Hungary combines the relatedness test with the threshold method by introducing a certain limit of exemption for income from unrelated commercial activities. As mentioned above, all economic activities that are included in the statute of the organization as supporting the mission are not subject to taxation. Income from

¹⁸ There are various approaches to dealing with the “relatedness” problem. In the U.S., the tax authorities determine whether the activity is “substantially related” to the public benefit purposes. To meet this test, the activity must be causally related to the NPO’s public benefit purposes and “contribute importantly” to it. I.R.C. 513(a) (1996). Hungary provides a list of “related” activities plus a catch-all provision, as discussed below in section 5(D)(2)(a). See also the Slovakian example from the same section.

One approach with particular merit is to pass a law covering the basic provisions of “relatedness” but leaving the task of preparing and enforcing precise definitions and practices to regulations or decrees. This guidance may take the form of a list of exempt activities, specific instructions, and/or explanations of examples.

¹⁹ See Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 Stanford L. Rev. 1017 (1982).



commercial/entrepreneurial activities (those that are unrelated to the mission) is taxed only if such income exceeds the envisioned threshold. For example, all NPOs, regardless of whether they acquired public benefit status or not, may benefit from tax exemption on the income from commercial activities which does not exceed 10% of total income or 10 million HUF (€38,892). Further, the Hungarian law also creates two categories of public benefit organizations, which are entitled to higher percentage of the exemption. Thus, organizations that have acquired public benefit status are exempt for commercial income that does not exceed 10% of total income or 20 million HUF (€77,785), and those who have obtained status of prominent public benefit organizations are exempt up to 15% of total income.

In *Czech Republic*, income from economic activities related to the statutory purposes of an NPO is subject to a reduced tax. All related income is exempt from income tax up to CZK 300,000 (€11,203). In addition, revenues (i.e., incomes minus related expenditures) at the end of fiscal year over this amount are reduced before taxation by 30% or CZK1 million (whichever is less) if the proceeds are used for public benefit purposes.

In *France*, earnings from economic activities are exempt from tax, provided that they are not distributed and that other features are present to distinguish the organization from a commercial entity. Specifically, NPOs with annual revenue exceeding €60,000 are eligible for tax-exempt status if: (1) management does not have a financial interest in the NPO; and (2) the NPOs do not compete with the commercial sector.²⁰ NPOs with annual revenue below €60,000 can receive tax-exempt status only if (1) not-for-profit activities are their predominant activities and (2) they do not distribute any income or assets to any private interests.

In *Germany*, public benefit organizations (PBO) may carry out business activities. Profits are free from corporate and commercial tax, as long as the business activities are necessary to pursue the PBO's statutory public benefit purposes (education, health care etc.). The same is true for charitable and church related purposes. Tax privileged purposes are listed in the law. In order to benefit from tax privileges, PBOs have to pursue these purposes and have to follow the principle of disinterestedness as defined in the law: they may not have as a prime aim the acquisition of income, they may use their resources only for statutory objectives, they may not distribute profits and may not pay disproportionately high salaries. They must use their resources within the year following the acquisition of the resources, but may build reserves within the margins mentioned in the law. Additionally, the organization must be set up exclusively for purposes that will make it eligible for tax exempted status and may compete with for-profit organizations

²⁰ If it is found that the NPO does compete with the commercial sector, an additional inquiry is conducted to see if the NPO conducts its activities along lines similar to those of the commercial sector.



only to the extent that such activities are “unavoidable”²¹. Unrelated commercial activities are ordinarily taxed if the income amounts to more than about €30.678.

In *Montenegro*, the profit from an organization’s economic activities is exempt up to 4,000 € and if used to further organizations statutory goals.

In *Romania*, non-profit legal persons are exempt from profit tax on income obtained through economic activities during a fiscal year, provided that the amount is less than the equivalent in Romanian currency of €15,000 for a fiscal year and not more than 10% of the total non-taxable revenue of the organization.

In *Slovakia*, NPOs are generally exempt from taxation on income from statutory activities. The non-statutory economic activities of NPOs are taxed at the general income tax rate, except that income from selling NPO property is tax exempt below SKK 300,000 (€8,935).

In *Serbia*, the income is exempted as long as it does not exceed 300,000 dinars (€ 3,782). This threshold is combined with the following conditions: (a) the income is not distributed to the founders, employees, members of the management board or persons affiliated with them; (b) the salaries do not exceed double the amount of the average salary paid in the field of economic activity in which an organization is engaged; (c) all earned profit was used to further the objectives for which the organization was created; and (d) the NPO's economic activities do not hamper competition with the private business sector as defined by the anti-trust law.

2. Rationale

One rationale for this approach is that the government can use it to limit the losses of tax revenue posed by the destination of income and relatedness methods of taxation.

A second rationale is that it is usually relatively easy to administer (although, as this approach is usually combined with another approach, administrative difficulties may remain).

Third, this approach discourages for-profit organizations from masquerading as NPOs to gain tax benefits and allays fears of unfair competition with the for-profit sector by restricting the amount of tax free profits an NPO may generate.

²¹ Based on discussion with the German expert on taxation, Dr. Michael Ernst-Pörksen (C.O.X. Steuerberatungsgesellschaft und Treuhandgesellschaft mbH)



Fourth, limiting tax benefits on income from economic activities can help preserve the integrity of the NPO sector by ensuring that the economic activity remains a supplemental, rather than main, activity of the NPO.

Finally, this approach still allows and encourages NPOs to engage in economic activity, at least up to a point and provides guarantees against the possible misuse of the income.

VI. CONCLUSION

Most countries in Europe permit most forms of NPOs to engage directly in economic activities. The legal framework that permits NPOs to engage in economic activities plays a critical role in encouraging the sustainability of the NPO sector. The income from economic activities is an important source of funding that allows NPOs to operate independently, to pursue their statutory goals, and to engage in services and activities in the public interest. Through generating own income from economic activities NPOs may be able to provide more, better, and less expensive services, at a savings to both the government and the individual beneficiaries of the services.

When regulating economic activities the following issues are generally addressed: a definition of what constitutes economic activities; criteria of what is permissible, and to what extent it is permissible; and the tax treatment of any revenue generated. The rules permitting or restricting economic activities are distinct from rules relating to the taxation of income from such activities – but they are closely related and work together to balance the benefits of allowing economic activities with the need for some limitations on those activities. Most countries broadly permit NPOs to engage in economic activities, but then use tax laws to insure that NPOs do not engage in economic activities to the extent that they become commercial companies.

There are various methods that can be used to determine the appropriate approach to regulation and taxation of economic activities. In deciding which approach to implement in the country it is important to consider the aims of the legislative reform, the local economy situation, the level of development of the NPO sector and its capacity, the level of engagement in economic activities, types of activities NPOs pursue and other factors. Thorough consideration of all factors will help ensure that the most appropriate strategies are adopted to support the aims of the regulation and ensure its effective implementation.